NO. 80359-5

WASHINGTON STATE SUPREME COURT

CERTIFICATION FROM
THE UNITED STATES DISTRICT COURT,
FOR THE WESTERN DISTRICT OF WASHINGTON

IN

ST. PAUL FIRE AND MARINE INSURANCE COMPANY,

Plaintiff,

vs.

ONVIA, INC., ONVIA.COM, and RESPONSIVE MANAGEMENT SYSTEMS, in its individual capacity and as class representative of a purported settlement class,

Defendants.

Response Brief of Defendant Responsive Management Systems

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I. INTRODUCTION

Under a third party liability policy, an insured may maintain a claim under Washington law for common law bad faith for a violation of the Washington Claims Handling Regulations or a violation of the Consumer Protection Act "CPA," RCW 19.86, even if there is a finding of no coverage. If this Court were to hold otherwise, it would sanction St. Paul's inadequate and insufficient claims handling in this case and signal to all insurers doing business in Washington that they can ignore Washington's Claims Handling Regulations with impunity so long as there is a finding of no coverage under the policy. Further, the Court will signal to all Washington insureds that the Washington Claims Handling Regulations no longer protect them unless a court eventually finds coverage under their policies. Under such a ruling, the Washington Claims Handling Regulations would effectively be rewritten to apply only where insureds tender an underlying complaint that is ultimately covered by the insurer's policy. Insureds tendering claims for which coverage is uncertain or not available would have no protection from improper and inadequate claims handling under common law or Washington regulations.

This Court should reject St. Paul's attempt to carve out an exception to well established law in an effort to excuse its alleged

unreasonable and unconscionable failure to handle Onvia's tender of the underlying fax blasting complaint properly under the Washington Claims Handling Regulations, allegedly failing to even respond to the tender for over eight months.[1] This Court has already held that procedural bad faith claims and CPA claims are separate and independent causes of action under Washington law and which survive a finding of no coverage. Further, this Court has already held that a rebuttable presumption of harm applies in *all* cases in which a liability insurer acted in bad faith. Finally, this Court has already held that where the insurer cannot rebut the presumption of harm, the estoppel remedy applies and the measure of damages for the insurer's bad faith is the amount of the stipulated judgment or judgment entered against the insured. RMS respectfully requests this Court reject St. Paul's arguments to the contrary.

II. CERTIFIED QUESTIONS

The district court certified the following questions to this Court for decision:

(1) Under Washington law, does an insured have a cause of action against its liability insurer for common law procedural bad faith for violation of the Washington Administrative Code and/or for violation of

[1] In the declaratory judgment action before Judge Lasnik in the Western District of Washington, RMS brought a common law procedural bad faith counter-claim under: (1) the tort of negligence; (2) the tort of procedural bad faith; and (3) for violation of the Consumer Protection Act. For purposes of these Certified Questions, these three causes of action are collectively referred to as "procedural bad faith."

the Washington Consumer Protection Act, even though a court has held that the insurer has no contractual duty to defend, settle, or indemnify the insured?

(2) If the Answer to the first question is "yes," then:

(a) Should the Court require the insured to prove that the insurer's conduct cause actual harm, or should the court apply a presumption of harm? and

(b) How should the insured's damages be measured?

III. SUMMARY OF ARGUMENT

Appellee RMS respectfully requests that this Court answer the Certified Questions as follows:

Certified Question no. 1: Yes, an insured may assert causes of action for common law procedural bad faith based on violations of the Washington Claims Handling Regulations and violation of the Consumer Protection Act despite a finding of no coverage under his insurance policy.

Certified Question no. 2(a): Assuming the Court answers question no. 1 in the affirmative, the Court should apply the rebuttable presumption of harm to shift the burden of proof on the element of harm to the insurer.

Certified Question no. 2(b): If the insurer fails to rebut the presumption of harm, the estoppel remedy applies, under which the

measure of damages is the amount of the judgment or stipulated judgment entered against the insured.

IV. ARGUMENT

A. Under Washington Law, an Insured has a Cause of Action Against its Liability Insurer for Common Law Procedural Bad Faith for Violation of the Washington Administrative Code and/or for Violation of the Washington Consumer Protection Act, Where a Court has Held there is no Coverage.

1. Existing Washington Law Allows Procedural Bad Faith and CPA Claims in the Absence of Coverage.

At the outset, it is important to note that the matter before this Court is not whether St. Paul *in fact* acted in bad faith against Onvia[2] in its insurance claims handling procedures. Rather, the issue before the Court is more theoretical: it is whether *any* insured in the State of Washington may plead a cause of action *at all* for the tort of procedural bad faith or violation of the CPA if it has been determined that the insurer has no contractual duty to defend, indemnify and settle.

Division One of the Washington Court of Appeals has already found that an insured may assert a claim for common law procedural bad faith and violation of the CPA once the court finds there is no coverage under a third party liability policy:

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[2] For purposes of this proceeding, Onvia and RMS, Onvia's assignee, are used interchangeably to refer to the Defendant Appellee. As Onvia's assignee, RMS holds all of Onvia's rights and claims against St. Paul. This Court should reject St. Paul's suggestion that RMS is not entitled to a full recovery because RMS acquired Onvia's claim against St. Paul as part of its settlement with Onvia. Br. of Appellant, p. 23.

> An insured may maintain an action against its insurer for bad faith investigation of the insured's claim and violation of the CPA regardless of whether the insurer was ultimately correct in determining coverage did not exist.

Torina Fine Homes, Inc. v. Mutual of Enumclaw Ins. Co., 118 Wn. App. 12, 20, 74 P.3d 648 (2003) (citing *Coventry Assocs. v. Am. States Ins. Co.* 136 Wn.2d 269, 279, 961 P.2d 933 (1998)).

In *Torina*, the insured home builder tendered an underlying complaint for construction defects to its liability insurer. The insurer initially denied coverage based on a factual mistake. Further investigation revealed the error, but also showed there was no coverage for a different reason.[3] The insured filed a declaratory judgment action against the insurer, alleging failure to properly and fully investigate the claim. The Court explained that:

> The implied covenant of good faith and fair dealing in the policy requires the insurer to perform any necessary investigation in a timely fashion and to conduct a reasonable investigation before denying coverage. If the insurer fails in either regard, it will have breached the covenant and, therefore, the policy.

Id. at 16 (citing *Coventry*, 136 Wn.2d at 281).

[3] The Court of Appeals found the record was insufficient to determine whether there was coverage under the policy. Whether or not the policy provided coverage for the underlying claim did not enter into the Court's decision.

The trial court held the insurer liable for procedural bad faith and CPA violations on summary judgment. On appeal, the Court allowed the insured to assert causes of action for procedural bad faith for failing to properly handle the claim and for violation of the CPA. *Id.* RMS respectfully requests that this Court follow the Court of Appeal's guidance in *Torina* and affirm the availability of procedural bad faith and CPA claims where the court has found there is no coverage.[4]

The *Torina* court relied on this Court's ruling in *Coventry Assocs. v. Am. States Ins. Co.*, 136 Wn.2d 269, 961 P.2d 933 (1998), in which the Court held that a first party insured may assert a claim for bad faith claims handling, including failure to investigate, and a CPA claim against its insured upon a finding of no coverage. Although St. Paul places great weight on a distinction between first and third party coverage claims, the *Torina* court found no reason to apply the rule differently in first and third party cases and applied the *Coventry* analysis without discussion.[5]

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[4] The *Torina* Court considered whether the insurer, in fact, breached its duty of good faith. The Court found the insurer's investigation was reasonable under the circumstances, so the insurer did not breach its duty of good faith. The *Torina* Court, therefore, never reached the element of harm and application of the rebuttable presumption of harm. In the present case, whether the parties can met any factual burdens of proof that may flow from the questions of law before this Court is not at issue.

[5] An insured purchases third-party coverage to protect himself against the potential claims of other people whom he might harm. First-party coverage, in contrast, allows an insured to make his own personal claim for payment against his insurer. *See* Thomas V. Harris, *Washington Insurance Law* §1.2 (2d ed. 2006) (discussing difference between first and third party coverage). The WAC Claims Handling Regulations use the term

In *Coventry*, this Court determined that first party insureds may plead a cause of action for the tort of bad faith and violation of the CPA, notwithstanding its finding of no coverage. This Court stated:

> We hold an insured may maintain an action against its insurer for bad faith investigation of the insured's claim and violation of the CPA regardless of whether the insurer was ultimately correct in determining coverage did not exist. An insurer's duty of good faith is separate from its duty to indemnify if coverage exists.

Coventry, 136 Wn.2d at 279; *see also Rizzuti v. Basin Travel Serv. of Othello*, 125 Wn. App. 602, 618, 105 P.3d 1012 (2005) ("[b]ecause an insurer's duty of good faith is separate from its duty to indemnify, an insured may maintain an action for bad faith investigation of the claim even if the insurer was ultimately correct in denying coverage").

The *Coventry* Court recognized the obvious public policy considerations inherent in the issue before the Court in this case. The Court understood that if it did not allow insureds to assert procedural bad faith and CPA claims despite a finding of no coverage, insurers would only owe a duty of good faith regarding claims handling when coverage was required. The Court squarely rejected this argument as counter to Washington law:

> Under American States' proposed rule, insurers would have a duty of good faith toward their insureds only when coverage

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"first party claimants," but define the term broadly to include insureds tendering both first and third party claims. WAC 284-30-320(3).

> was required. That reasoning begs the question and *runs counter to our previous holdings*.

Coventry, 136 Wn.2d at 280 (emphasis added).

St. Paul argues that an insured may not bring an action for procedural bad faith in the third party context where there is no coverage and that this Court should not *extend* the ruling in *Coventry* to apply in the context of third party liability coverage. The irony in St. Paul's argument is that in *Coventry*, the Washington Supreme Court assumed the rule already applied in the third party context. *Coventry*, 126 Wn. App. at 277. The issue before the *Coventry* Court was whether the rule should be *extended* from the *third* party context to the *first* party context:

> This issue is one of first impression in the context of a first party action. In the context of a third party reservation of rights case, once an insured meets its burden of establishing an insurer's bad faith, a rebuttable presumption of harm arises.

Coventry, 136 Wn.2d at 277.

As in *Torina*, the *Coventry* Court rejected the argument that the rule could not apply equally to first and third party claims. The *Coventry* Court further signaled that its ruling encompasses first and third party claims by explicitly overruling *Farrington Corp. v. Commonwealth Land Title Ins. Co.*, 86 Wn. App. 399, 936 P.2d 1157 (1997), a third party case in which this Court had found the insured could not assert a procedural

bad faith claim after a finding of no coverage. In *Coventry*, this Court stated, "*Farrington* is inconsistent with our holding in this case, and to the extent it stands for a proposition counter to our holding, it is overruled." *Coventry*, 136 Wn.2d at 280 n.3.

St. Paul also places great weight on a distinction between procedural and substantive bad faith claims, arguing that procedural bad faith claims should be analyzed and applied differently from substantive bad faith claims. Here again, St. Paul misconstrues bad faith law in Washington. The *Coventry* court rejected the distinction between procedural and substantive bad faith that St. Paul tries to draw. This Court's decision in *Coventry* explicitly rejected the lower court's distinction between substantive and procedural bad faith:

> Here, the Court of Appeals procedural/substantive distinction is not based on the insurance contract or the insured's statutory obligations. In fact, under the insured's statutory obligations, the question becomes a precise one: either the insurer complies with those duties or it does not. When the insurer does not comply with those obligations in bad faith a cause of action exists.

Coventry, 136 Wn.2d at 281.

The Court in *Coventry* equated the procedural (claims handling) bad faith issue before it with the substantive (whether there is coverage)

bad faith issue before the court in *Safeco Ins. Co. v. Butler*, 118 Wn.2d 383, 823 P.2d 499 (1992). Further, as the Court affirmed in *Besel v. Viking Insurance Co. of Wisconsin,* 146 Wn.2d 730, 737, 49 P.3d 887 (2002), bad faith is the same cause of action with the same remedies, regardless of the source of the insurer's bad faith conduct:

> The principles in *Butler* [presumption of harm, estoppel remedy] do not depend on how an insurer acted in bad faith. Rather, the principles apply whenever an insurer acts in bad faith, whether by poorly defending a claim under a reservation of rights, *Butler*, 118 Wash.2d at 390-92, 823 P.2d 499; refusing to defend a claim, *Kirk v. Mount Airy Insurance Co.*, 134 Wash.2d 558, 565, 951 P.2d 1124 (1998); or failing to properly investigate a claim; *Coventry Associates v. American States Insurance Co.*, 136 Wash.2d 269, 961 P.2d 933 (1998).

Id.

Indeed, by ruling as it did, the *Coventry* Court explicitly extended the third party bad faith analysis to the first party context precisely to provide first party insureds with the same protection already afforded to third party insureds. 136 Wn.2d 269. The Court also explicitly rejected any distinction between substantive and procedural bad faith, reaffirming long standing Washington law that bad faith conduct of *any* kind subjects an insurer to liability. The *Coventry* Court simply did not import the presumption of harm and the measure of damages along with the third

party bad faith analysis, because they did not apply in the first party context. A decision by this Court now that an insured cannot assert a claim for procedural bad faith and violation of the CPA in the third party context, where there is a finding of no coverage, would significantly depart from the long line of Washington decisions to the contrary, including *Coventry* and *Besel*.

2. Common Law Bad Faith and CPA Claims Are Separate and Independent Claims under Washington Law, Not Derivative or Conditional as St. Paul Argues.

Bad faith law developed in Washington to protect insureds from improper coverage decisions and inadequate and wrongful claims handling by insurance companies. In *Kirk v. Mt. Airy Insurance Co.*, 134 Wn.2d 558, 562, 951 P.2d 1124 (1998), this Court stated that: "bad faith requires us to set aside traditional rules regarding harm and contract damages because insurance contracts are different." The Court explained further that: "[w]hen dealing with an insurance contract, we cannot focus solely on the contractual aspect of the relationship, and we must take into account the purpose of creating a bad faith cause of action." *Id.* at 564 (citing *Butler*, 118 Wn.2d at 393-94.) To address the harm an insured can suffer outside of the terms of the contract, such as when the insurer fails to handle an insurance claim in good faith; the Washington court adopted the

separate tort of bad faith.[6] The Washington legislature has imposed on insurers a duty of good faith under RCW 48.01.030 as well. The Insurance Commissioner promulgated regulations defining specific acts and practices which constituted a breach of the insurer's duty of good faith. WAC 284-30-300.[7]

"An action for bad faith handling of an insurance claim sounds in tort." *Butler,* 118 Wn.2d at 389. Tort obligations are imposed by law based on policy considerations to avoid some kind of loss to others. *Prosser & Keeton on The Law of Torts,* § 92 at p. 656 (W. Page Keeton ed., 5th ed. 1984). "Claims of insurer bad faith are analyzed applying the same principles as any other tort: duty, breach of that duty, and damages proximately caused by any breach of duty." *Mutual of Enumclaw Insurance Co. v. Dan Paulson Constr., Inc.,* __ Wn.2d __, 169 P.3d 1, 8 (Oct. 11, 2007) (citation omitted). The duty of care under the tort of bad faith is owed to all insureds, and it exists regardless of whether a court

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[6] St. Paul quotes commentator Thomas Harris out of context, Br. of Appellant, pp. 9-10, to suggest that Mr. Harris believes an insurer owes no duty to an insured outside the contract. In his chapter on bad faith, Mr. Harris recognizes the insurer's good faith obligation to comply with the WAC regulations: "[WAC 284-30-300] is not exclusive and other activities may be deemed to constitute violations of the general good faith standard established by RCW 48.01.030." Harris, *supra,* § 7.1.

[7] Under *Industrial Indemnity Co. of the Northwest, Inc. v. Kallevig,* 114 Wn.2d 907, 792 P.2d 520 (1990), a single violation of a WAC claims handling regulation supports a claim for violation of the Washington Consumer Protection Act. St. Paul cites no Washington law in support of its argument that a third party insured may not assert a CPA claim after a finding of no coverage because there are no such cases. Nowhere in the legislative and regulatory protections giving rise to a CPA claim for improper claims handling is there a basis for the exceptions St. Paul seeks.

determines that there is coverage and a duty to defend in any particular instance. As this Court has stated in *Coventry*, "insurers have a general duty of good faith in their actions with their insureds." 136 Wn.2d at 279-80 (emphasis added); s*ee Tank v. State Farm Fire & Cas. Co.*, 105 Wn.2d 381, 385-86, 715 P.2d 1133 (discussing fiduciary relationship between insurer and insured, and duty to act in good faith). The duty of care, requiring good faith conduct in the handling of insurance claims, cannot be limited, as St. Paul argues, only to those insureds to which coverage is extended.

As explained above, St. Paul's suggestion that "the duty to defend is the source of and *prerequisite* to every other duty a liability insurer owes," Br. of Appellant, p. 7 (emphasis added), has already been rejected by the Washington court in *Torina*, 118 Wn. App. 12 (separate claim exists for bad faith investigation absent coverage); and in *Coventry*, 136 Wn.2d at 279 ("An insurer's duty of good faith is separate from its duty to indemnify if coverage exists.").

The Supreme Court of South Carolina reviewed many cases on the insured's ability to assert procedural bad faith claims in the absence of coverage in *Tadlock Painting Co. v. Maryland Casualty Co.*, 322 S.C. 498, 473 S.E.2d 52 (1996), in which the court answered the same question posed here on certification from the Fourth Circuit Court of Appeals. The

underlying claim involved damage to ninety cars from paint overspray. When a coverage issue developed over application of a deductible, the insurer refused to process the car owner's claims against the insured painting contractor. At trial, the Court ruled against the insured on coverage, finding that the deductible applied. The insured sued for bad faith claims handling, arguing that the delay in handling the overspray claims damaged the insured's business. *Id.*

Just as St. Paul does here, the insurer in *Tadlock* argued that the insured should only be allowed to assert bad faith claims where the insurer breached the duty to defend or indemnify under the policy. The insurer argued, further, that if there were no coverage, the insured could not assert a procedural bad faith claim. The South Carolina Supreme Court disagreed, finding, that the "insured does not need to prevail on the contract claim to prevail on the claim for breach of implied covenant [of good faith]." *Id.* at 54 n.4 (quoting *State Farm Mut. Auto. Ins. Co. v. Shrader*, 882 P.2d 813, 828 (Wyo. 1994)). The Court stated, further, that a bad faith claim exists separately from an action in contract. *Id.* As a result, the bad faith claim is not conditioned on a finding of coverage nor is a claim for procedural bad faith derivative of a claim for coverage. *See Deese v. State Farm Mut. Auto. Ins. Co.*, 172 Ariz. 504, 838 P.2d 1265 (1992) (en banc) (claim for procedural bad faith lies where insurer has not

committed substantive bad faith) (cited with approval in *Coventry*, 136 Wn.2d at 280 n.2); *White v. Unigard Mut. Ins. Co.*, 112 Idaho 94, 730 P.2d 1014, 1017 (1986) (holding an insured may sue for bad faith, even if the claim is not covered, when the insurer intentionally and unreasonably delays payment on a claim and the delay harms the insured) (cited with approval in *Coventry*, 136 Wn.2d at 279).

Here, St. Paul's reliance on *Felice v. St. Paul Fire & Marine Insurance Co.*, 42 Wn. App. 352, 711 P.2d 1066 (1985), is particularly misplaced. St. Paul fails to tell the Court that *Felice* involved the insured's failure to notify his insurer of the underlying action for which he sought coverage until seven months after the claim went to trial. Not surprisingly, the court held the insured's delay in providing notice to the insurer actually prejudiced the insurer, which precluded the insured's claim for procedural bad faith. Given the insured's late notice and breach of the co-operation clause, *Felice* provides no guidance on the issue before this Court.

St. Paul's citation to three decisions from California is equally unhelpful. *Waller v. Truck Ins. Exch., Inc.,* 11 Cal. 4th 1, 44 Cal. Rptr. 2d 370 (1995); *Buena Vista Mines, Inc. v. Indus. Indem. Co.*, 87 Cal. App. 4th 482, 104 Cal. Rptr. 2d 557 (2001); and *R&B Auto Center, Inc. v. Farmers Group, Inc.*, 140 Cal. App. 4th 327, 44 Cal. Rptr. 3d 426 (2006), provide,

as St. Paul argues, that in the absence of coverage, the insured cannot assert a procedural bad faith claim for improper claims handling. Indeed, these out of state decisions support exactly the argument St. Paul makes here. They are easily distinguishable on the simple ground that they bear no relation to Washington law as set forth above. St. Paul's inclusion of the California decisions underscores the obvious fact that St. Paul cannot cite to any Washington decision in line with the three from California, just as St. Paul has not cited to any Washington decision squarely in support of its argument.

The duty to act in good faith is an obligation imposed by law, both statutory and judge-made, based on policy considerations. The tort of bad faith is independent of and stands apart from the insured's contractual rights set forth in the policy. Further, the only Washington case to hold otherwise, *Farrington,* 86 Wn. App. 399, was explicitly overruled by this Court in *Coventry*, 136 Wn.2d at 280 n.3.

3. St. Paul Asks this Court to Nullify Important Protections Afforded to All Insureds Under the Washington Claims Handling Regulations.

St. Paul asks this Court to rewrite the regulations so they no longer apply where an insured tenders a third party claim for which it turns out there is no coverage. This Court cannot rule in St. Paul's favor without substantially undercutting the long standing legislative and regulatory

scheme adopted in Washington specifically to protect all insureds from the type of improper claims handling conduct St. Paul is alleged to have exhibited in this case.

St. Paul argues that the recent Court of Appeals decision in *Shields v. Enterprise Leasing Co.*, 139 Wn. App. 664, 161 P.3d 1068 (2007), requires this Court to restrict procedural bad faith claims to cases where the insurer has coverage. Even St. Paul admits, however, that the *Shields* decision is not on point because the insured in that case never purchased liability coverage and, therefore, never created a contractual relationship with the claimant. Indeed, in *Shields*, the Court specifically recognized RMS's argument, stating that: "[i]ndependent of whether an insurer must provide coverage, an insured may bring a claim for violation of the CPA and bad faith." 139 Wn. App. at 676 (citing *Coventry*, 136 Wn.2d at 279, and *Anderson v. State Farm Mut. Ins. Co.*, 101 Wn. App. 323, 329, 2 P.3d 1029 (2000)).

Nevertheless, St. Paul equates the complete lack of contractual relationship in *Shields* with the present case where there was a contractual relationship, but no coverage. St. Paul argues it should owe no duty whatsoever under both scenarios. Br. of Appellant, p. 13. By doing so, St. Paul reveals the fundamental fallacy of its argument. St. Paul argues that it has no obligation to comply with the WAC regulations because it

had no coverage for the tendered claim. This is not and never has been the law in Washington. The WAC regulations establish minimum claims handling practices to be followed by *all* insurers in Washington when they receive tender of *all* claims for coverage.[8] The regulations do not contain any restriction on their application to first or third party claims, nor do they contain any restrictions as to covered or non-covered claims.

Under the current regulatory scheme, *every* Washington insured is protected under WAC 284-30-330 against the following unfair claims practices:

> (2) Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies.
>
> (3) Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under insurance polices.
>
> (4) Refusing to pay claims without conducting a reasonable investigation

WAC 284-30-360 establishes standards for communications with the insured:

> (1) Every insurer, upon receiving notification of a claim shall, within ten working days, acknowledge the receipt of such notice unless payment is made within such period of time.
>
> (3) An appropriate reply shall be made within ten working days . . . on all other pertinent communications from a

[8] Harris, *supra*, § 7.1.

> claimant which reasonably suggests that a response is expected.

WAC 284-30-370 establishes the standard for prompt investigation of all claims by all insurers:

> *Every* insurer shall complete investigation of a claim within thirty days after notification of a claim, unless such investigation cannot reasonably be completed within such time. (emphasis added)

RMS alleges that St. Paul's claims handling in this case violated each of the WAC regulations quoted above.[9] St. Paul wants the Court to create an exception for insurers handling third party liability claims for which a court eventually finds there is no coverage. St. Paul's position is an attack on the rights of Washington insureds under the insurance regulations. St. Paul is really asking this Court to adopt a "no harm no foul" analysis on the ground that where the insured has no coverage for the tendered claim, the insurer's claims handling conduct could not possibly harm the insured.[10] Fortunately for insureds in Washington, this Court soundly rejected this proposition in *Coventry*:

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[9] While allegations of a failure to investigate come within a procedural bad faith claim, RMS's bad faith claim against St. Paul is based on WAC 284-30-300 (2)-(4), WAC 284-30.360 (1) and (3) and WAC 284-30-370, and is, therefore, far broader than failure to investigate.

[10] Courts in Washington consistently rejects the "no harm, no foul" analysis in the bad faith context. *Besel*, 146 Wn.2d at 737 (insured's settlement with a covenant not to execute did not immunize insured from bad faith liability even though insured was not liable for stipulated judgment); *Specialty Surplus Ins. Co. v. Second Chance, Inc.*, No. 03-927, 2006 WL 2459092 (W.D. Wash. Aug. 22, 2006) (insured's bankruptcy did not

> American States would have us adopt the same "no harm, no foul" rule in which bad faith is not actionable, as a matter of law, when the insured's policy does not provide coverage for the loss. *We declined to do so.*

Id. at 278 (emphasis added).

In *Rawlings v. Apodaca,* 151 Ariz. 149, 726 P.2d 565, 573 (1986), an Arizona decision on which *Coventry* relies, the court explained why the procedural bad faith claim in the absence of coverage is so valuable to a third party insured:

> In both first and third party situations the contract and the nature of the relationship effectively give the insurer an almost adjudicatory responsibility. The insurer evaluates the claim, determines whether it falls within the coverage provided, assesses its monetary value, decides on its validity and passes upon payment.

Rawlings, 726 P.2d at 570.

To protect the insured from the insurer's potential mishandling of these responsibilities, the Arizona Supreme Court set forth a separate and independent claim for procedural bad faith regardless of whether coverage is afforded under the policy:

> In special contractual relationships, when one party intentionally[11] breaches the

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immunize insurer from bad faith liability for failing to convey a settlement demand the insured could not have paid).

[11] The *Rawlings* Court clarified its use of the term "intentionally" here, equating it to the bad faith standard under Washington law for which an intent to harm is not required. 726 P.2d at 576.

> implied covenant of good faith and fair dealing, and when contract remedies serve only to encourage such conduct, it is appropriate to permit the damaged party to maintain an action in tort and to recover tort damages.

Id. at 576.

Unfortunately for RMS, St. Paul has chosen to litigate this case in five separate state and federal courts[12] rather than complying with the Washington Claims Handling Regulations in the first place. Insureds who are denied coverage have paid the same premiums as those who are afforded coverage, and should receive the same treatment in having their claims fairly and honestly investigated and processed, regardless of whether it is later determined that they have no coverage.

As a practical matter, St. Paul's position is unenforceable. Under St. Paul's theory, an insurer would not have a present duty to comply with the WAC regulations upon receipt of tender if it believed there were no coverage under the policy. Washington law is replete with examples where insurers concluded there was no coverage, only to be corrected later by the court. There should be no uncertainty as to whether an insurer must

[12] St. Paul filed a declaratory judgment action in the Western District of Washington, *St. Paul v. RMS et al.* C06-1056-RSL (W.D. Wa. 2006), which is on appeal in the Ninth Circuit, *appeal docketed*, No. 07-35549. St. Paul intervened in the underlying state court action, *Responsive Management Systems v. Onvia, Inc.*, King County Superior Court No. 05-2-04728-3 SEA, and appealed the reasonableness of the stipulated judgment to the state appellate court, Court of Appeals for the State of Washington, Division I, Case no. 59282-3. The matter is also before the state Supreme Court on these Certified Questions.

comply with the WAC regulations in handling a given claim. Such uncertainty will only result in delay and the expense of further litigation. The only means of ensuring that every insured's claim is treated properly and equally under the WAC regulations is to reject St. Paul's request for an exception to the current legislative and regulatory scheme.[13]

In conclusion, under existing Washington law, an insured may maintain a claim for procedural bad faith and violation of the CPA despite a finding of no coverage. Washington law recognizes separate and independent claims for procedural bad faith and CPA violations that are not conditioned on the existence of coverage. The Washington Court has already rejected the limitations on procedural bad faith claims against liability carriers that St. Paul asks this Court to impose. The Washington Claims Handling Regulations apply to St. Paul's claims handling conduct in this case. The special exception St. Paul seeks will leave thousands of Washington insureds without regulatory claims handling protection. For these reasons, this Court should answer Certified Question no. 1 in the affirmative.

[13] The Insurance Fair Claims Act, RCW 48.30.010-015, (the "Act") became effective December 6, 2007. The Act most likely does not apply to this case. Nevertheless, RMS notes that the Act recognizes a separate cause of action for procedural bad faith claims in first and third party cases.

B. The Court Should Apply the Rebuttable Presumption of Harm to the Insured's Claim for Procedural Bad Faith in the Absence of Coverage.

This Court has already ruled on the second Certified Question, holding that the rebuttable presumption of harm applies to all third party bad faith claims, regardless of the source of the bad faith. *Besel*, 146 Wn.2d at 737. If the Court finds that an insured may maintain a claim for procedural bad faith absent coverage in a third party liability case, then the Washington court applies the rebuttable presumption of harm to satisfy the insured's burden to prove the element of harm resulting from the insurer's bad faith. There is no support for St. Paul's request to carve out an exception for third party procedural bad faith claims that survive a finding of no coverage. Indeed, since adopting the rebuttable presumption in *Butler,* 118 Wn.2d at 392, this Court has applied the rebuttable presumption of harm in increasingly broader scenarios as explained below and has never failed to apply the presumption in a third-party case.

In *Butler,* this Court imposed a rebuttable presumption of harm to satisfy the insured's burden to prove harm where the insurer handled a reservation of rights defense in bad faith because "[t]he insured should not have the almost impossible burden of proving that he or she is demonstrably worse off because of [the insurer's actions]." *Butler*, 118 Wn.2d at 390 (quoting Alan D.Windt, *Insurance Claims and Disputes:*

Representation of Insurance Companies and Insureds § 2.09, at 40-41 (2d ed. 1988)). Presuming prejudice once bad faith is established properly shifts the burden to the insurer to prove its actions did not harm the insured. *Butler*, 118 Wn.2d at 392. "The shifting of the burden ameliorates the difficulty insureds have in showing that a particular act resulted in prejudice." *Id.* Finally, and pointedly, the *Butler* Court explained that, "imposing a presumption of prejudice only after the insured shows bad faith adequately protects the competing societal interests involved. It provides a meaningful disincentive to insurer's bad faith conduct while protecting insurers from frivolous claims." *Id.* The same public policy interests supporting use of the rebuttable presumption of harm in this case. *Paulson* 169 P. 3d 1.

St. Paul's argument that this Court should refuse to apply the presumption of harm required by *Butler* and its progeny to claims of procedural bad faith ignores the breadth of the *Butler* decision. The Court in *Butler* did not limit application of the rebuttable presumption of harm to specific types of bad faith conduct or to specific types of policies or claims for coverage. To the contrary, the Court broadly stated, "we presume prejudice in *any* case in which the insurer acted in bad faith." *Butler*, 118 Wn.2d at 391 (emphasis added).

Six years later, in *Kirk*, 134 Wn.2d at 562, this Court considered whether the rebuttable presumption of harm applies when the insurer refuses to defend in bad faith. Answering in the affirmative, this Court applied the rebuttable presumption of harm even though *Kirk* did not involve a reservation of rights defense. *Id.* As the Court held in *Tank*, 105 Wn.2d at 385, every third party liability policy carries with it a fiduciary relationship between the insured and the insurer that gives rise to the duty of good faith and fair dealing:

> Such a relationship exists not only as a result of the contract between insurer and insured, but because the high stakes involved for both parties to an insurance contract and the elevated level of trust underlying insureds' dependence on their insurers. This fiduciary relationship, as the basis of an insurer's duty of good faith, implies more than the "honesty and lawfulness of purpose" which comprises a standard definition of good faith. It implies "a broad obligation of fair dealing..."

Id. (citation omitted).

In 2002, this Court reaffirmed the broad application of the rebuttable presumption of harm in *Besel*, 146 Wn.2d at 737, with the following oft-quoted statement that the rebuttable presumption applies whenever an insurer acts in bad faith:

> [T]he principles [set out in Butler and the application of the rebuttable presumption of

> harm] apply whenever an insurer acts in bad faith, whether by poorly defending a claim under a reservation of rights, refusing to defend a claim, or failing to properly investigate a claim.

Id. at 737 (emphasis added, citations omitted).

Indeed, this Court recently held that an insurer's subpoena to and ex parte communications with the arbitrator in an underlying defense action constituted bad faith and applied the rebuttable presumption of harm once again. *Paulson*, 169 P.3d 1.

St. Paul's protestations that harm should not be presumed when an insurer commits procedural bad faith, because "there is no reason to suspect that events would have transpired differently" had there been no procedural bad faith, underscores St. Paul's misunderstanding of Washington case law. Br. of Appellant, p. 20. The whole point is that the burden does not lie with the insured to establish the "almost impossible burden...that he or she is demonstrably worse off because of [the insurer's bad faith.]" *Paulson*, 169 P.3d at 11 (quoting *Butler*, 118 Wn.2d at 390). Instead, this Court places the burden on the insurer to prove that its bad faith conduct did not harm the insured, based on policy considerations:

> The nature of the tort of insurer bad faith dictates that the almost impossible burden of proof will fall either on the insured or the insurer. As the *Butler* court recognized, "[t]he course cannot be rerun, no amount of

> evidence will prove what might have occurred if a different route had been taken." Either the insured will face the almost impossible burden of proving that 'he or she is demonstrably worse off because of' the insurer's bad faith or the insurer will face the almost impossible burden of proving the reverse. As between the insured and the insurer, it is the insurer that controls whether it acts in good faith or bad. Therefore, it is the insurer that appropriately bears the burden of proof with respect to the consequences of that conduct.
>
> With the *Butler* presumption of harm, this court announced a policy choice to protect third-party insureds and dissuade insurer bad faith. In the more than 15 years that have elapsed since *Butler*, the legislature has not altered the *Butler* presumption, nor has this court retreated from it.

Paulson, 169 P.3d at 11 (citations omitted).

St. Paul makes the illogical argument that although the rebuttable presumption of harm was developed in the third party context, this Court should not apply the rebuttable presumption to the procedural bad faith claims in this third party case. St. Paul points to the *Coventry* Court's decision not to import the rebuttable presumption of harm along with the procedural bad faith claim adopted from third party cases, without realizing the circularity of the argument. St. Paul over looks the circularity of its argument. The *Coventry* Court declined to apply the rebuttable presumption of harm in the first party context precisely because

the presumption of harm was developed in the third party context. The *Coventry* Court's frame of reference was the *Butler* decision in which the rebuttable presumption applied because of the heightened duty of good faith given the potential conflict of interest in reservation of rights cases. *Coventry*, 136 Wn.2d at 281. As explained above, the rebuttable presumption of harm has not been limited to third party reservation of rights cases for ten years and now applies to *all* types of bad faith in third party cases. *Besel,* 146 Wn.2d at 737.

In conclusion, following the *Butler, Kirk, Besel,* and *Paulson* decisions, and given the clear and unwavering principles announced therein, this Court should answer Certified Question no. 2(a) by finding that the rebuttable presumption of harm applies. Under Washington law, a rebuttable presumption of harm applies whenever an insurer commits procedural bad faith, including claims for procedural bad faith after a finding of no coverage. St. Paul has failed to provide any reasoned analysis to hold to the contrary.

C. Upon a Finding Of Bad Faith, Estoppel Applies, And the Amount of the Stipulated Judgment is the Presumptive Measure of Damages.

This Court has also already decided the Certified Question no. 2(b) in the affirmative. It is well established under Washington law that if a liability insurer cannot rebut the rebuttable presumption of harm, the

remedy is estoppel, and the stipulated judgment is the presumptive measure of damages. *Paulson*, 169 P.3d 1. Just as for the rebuttable presumption of harm, there is no reasoned basis for this Court to carve out a special exception to this rule for procedural bad faith claims asserted after a finding of no coverage.

As explained above, the Washington court applies a rebuttable presumption of harm upon a showing of bad faith to shift the burden of proof on the element of harm from the insured to the insurer. *Butler*, 118 Wn.2d at 390; *Kirk*, 134 Wn.2d at 562; *Paulson*, 169 P. 3d 1. The insurer is then afforded the opportunity to rebut the presumption of harm. *Paulson*, 169 P. 3d at 10. This means the insurer has a chance to prove that the insured did not, in fact, suffer any harm or prejudice as a result of the insurer's bad faith conduct. *Id.* If the insurer meets this burden, then the insured will not recover on its bad faith claim. Only if the insurer fails to prove that the insured suffered no harm will the case proceed to the remedy phase. Thus, when the court considers the applicable remedy, the insurer has already been found to have acted in bad faith which has resulted in harm or prejudice to the insured. *Butler*, 118 Wn.2d at 392; *Kirk*, 134 Wn.2d at 564.

Since this Court issued its ruling in *Butler* fifteen years ago, the only remedy applied in third party bad faith cases has been estoppel,

which bars the insurer from asserting any of its coverage defenses. Where the insurer's coverage defenses are estopped, including the policy limits, the insurer becomes liable for the entire underlying liability against the insured, which is established by the judgment or a stipulated judgment entered against the insured. *Besel*, 146 Wn.2d at 737. Under Washington law, therefore, the amount of the stipulated judgment is presumed to be the measure of damages:

> We hold the amount of a covenant judgment is the presumptive measure of an insured's harm caused by an insurer's tortuous bad faith if the covenant judgment is reasonable under the [*Chaussee v. Maryland Casualty Co.*, 60 Wn. App. 504, 803 P.2d 1339, 812 P.2d 487 (1991)] criteria.

Besel, 146 Wn.2d at 738.[14]

If the this Court affirms that RMS may assert a claim for procedural bad faith against St. Paul and applies the rebuttable presumption of harm, then St. Paul will have an opportunity to rebut the presumption of harm. If St. Paul proves RMS suffered no harm or prejudice resulting from St. Paul's alleged violations of the Washington Claims Handling Regulations, then RMS will not recover damages for its bad faith claim. Only if St. Paul cannot meet its burden to prove no harm

[14] Here, the trial court in the underlying action found the stipulated judgment to be reasonable under the *Chaussee* factors. St. Paul appealed this finding to Division I of the Court of Appeals. *See* footnote no. 12.

or prejudice will estoppel apply, making the stipulated judgment the presumptive measure of damages.[15]

The stated purpose of the estoppel remedy in third party bad faith cases is to provide an incentive to insurers to act in good faith when handling their insured's claims, including compliance with the Washington Claims Handling Regulations. In *Butler*, 118 Wn.2d at 394, this Court explained, first, that in fashioning a remedy for bad faith conduct, the court must take into account all aspects of the insurer/insured relationship, not just the contract aspect. Second, the remedy must take into account the purpose of creating a bad faith cause of action:

> If the only remedy available were the limits of the contract, then there would be no distinction between an action for an insurer's wrongful but good faith conduct, and an action for its bad faith conduct. An insurer could act in bad faith without risking any additional loss . . . An estoppel remedy, however, gives the insurer a strong disincentive to act in bad faith.

Id. at 394.

This Court reaffirmed the estoppel remedy's role as an important incentive to handle claims in good faith in each of its third party bad faith decisions since *Butler*, 118 Wn.2d 383. *Kirk*, 134 Wn.2d at 564 ("The

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[15] St. Paul's citation to *Hayden v. Mutual of Enumclaw Insurance Co.*, 141 Wn.2d 55, 1 P.3d 1167 (2000), does not support St. Paul's position because it did not involve a procedural bad faith claim. Estoppel is appropriate in the present case if RMS proves procedural bad faith.

coverage by estoppel remedy creates a strong incentive for the insurer to act in good faith, and protects the insured against the insurer's bad faith conduct"); *Truck Ins. Exch. v. Vanport Homes Inc.*, 147 Wn.2d 751, 765, 558 P.3d 276 (2002) ("To limit an insurer's liability to its indemnity limits would only reward the insurer for failing to act in good faith toward its insured"); *Besel*, 146 Wn.2d at 740 ("it was within Viking's power to limit its liability by acting in good faith"); *Paulson*, 169 P.3d at 10.

St. Paul seeks to limit procedural bad faith liability, where there is no coverage, to the amount necessary to put the insured in as good a position as if there had been no bad faith conduct. Br. of Appellant, p. 21. This is the very same remedy for an ordinary breach of contract that this Court has repeatedly rejected as inadequate to compensate an insured for tortuous bad faith conduct by the insurer. It is equally insufficient to provide the incentive necessary for insurers to act in good faith. *Butler*, 118 Wn.2d at 393; *Kirk*, 134 Wn.2d at 564.

Just as above with respect to the rebuttable presumption of harm, St. Paul's reliance on *Coventry*, 136 Wn.2d 269, to argue that the third party estoppel remedy should not apply in this third party case is misplaced. Br. of Appellant, p. 23. The *Coventry* Court explained why estoppel should not apply in the first party context. The *Coventry* Court did not, as St. Paul suggests, address all of the reasons why this Court now

applies the estoppel remedy in all third party bad faith cases. 136 Wn.2d at 284-85.

St. Paul also argues that it would be inequitable or arbitrary for this Court to apply the estoppel remedy because the amount of the stipulated judgment is disproportionate to the actual harm. Br. of Appellant, p. 22. Again, St. Paul misconstrues existing Washington law. Estoppel will only apply if St. Paul cannot show that its bad faith conduct failed to harm its insured. If the presumption of harm survives the evidence St. Paul submits in rebuttal, the insured will be deemed to have been harmed. Under Washington law, the court does not consider the nature, scope or monetary amount of the harm or prejudice the insured suffered. If there is any harm, the stipulated judgment is the presumptive measure of damages. This is best demonstrated by this Court's recent decision in *Paulson*, 169 P.3d 1, where the underlying action involved both covered and non-covered claims. The insured's retained defense counsel and the plaintiff chose not to have the arbitrator allocate damages between covered and non-covered claims. The insurer sent two *ex parte* letters and a subpoena to the arbitrator shortly before the arbitration hearing asking the arbitrator to allocate the damages between covered and non-covered claims. *Id.* at 8-9. The Court held that the insurer committed bad faith by improperly interfering with its insured's defense in the underlying arbitration.

The *Paulson* Court's analysis of the insurer's attempt to rebut the presumption of harm is highly instructive in this case. The insurer argued that the insured's decision to proceed with the arbitration despite the bad faith conduct, coupled with a settlement and covenant judgment within policy limits rebutted the presumption of harm. The insurer also argued that the attorneys' fees incurred by the insured to respond to the improper ex parte communications and subpoena were too small to justify applying estoppel and thereby holding the insurer liable for the entire stipulated judgment. These are the same arguments St. Paul makes here: (1) that the insured suffered no harm; and (2) that where the insured only suffers a relatively small monetary harm, the court should not apply the estoppel remedy and hold the insurer liable for the entire stipulated judgment.

This Court rejected the insurer's arguments, finding that the insurer's bad faith harmed and prejudiced the insured in a number of non-monetary ways:

> [T]he record supports that [the insurer's] conduct caused significant uncertainty and increased risk for [the insured's] defense. [The insurer] bad faith conduct interfered in [the insured's] final hearing preparation, interjected insurance coverage issues into the arbitration, and created uncertainty concerning potential prejudicing of the arbitrator and the effect of [the insurer's] interference on the confirmability of the arbitration award.

Paulson, 169 P.3d at11-12.

Based on the non-monetary prejudice suffered by the insured, the Court held that the insurer failed to rebut the presumption of harm. Following *Besel*, 146 Wn.2d at 738, the Court applied the estoppel remedy and found that the covenant or stipulated judgment was the correct measure of harm. By committing bad faith, the insurer, "voluntarily forfeited its ability to protect itself against an unfavorable settlement." *Paulson*, 169 P.3d at 13 (quoting *Vanport*, 147 Wn.2d at 765-6).

There is no reason for this Court to depart from the controlling precedent established in *Butler, Kirk, Besel, Vanport,* and *Paulson.* Where a third party liability insurer fails to rebut the presumption of harm, the remedy under Washington law is estoppel, under which the judgment or stipulated judgment entered against the insured is the correct measure of harm. In *Paulson*, 169 P.3d 1, this Court recognized the important role played by the non-monetary prejudice suffered by an insured when its insurer acts in Bad Faith. This Court also reaffirmed the Washington rule that where the insurer fails to prove no harm, estoppel applies regardless of the nature, scope or amount of the harm or prejudice suffered by the insured. For these reasons, this Court should answer Certified Question no. 2(b) in the affirmative.

D. Conclusion

Based on the foregoing, RMS respectfully requests that this Court answer Certified Question no. 1 in the affirmative. Under established Washington law, an insured may assert procedural bad faith and CPA claims despite a finding of no coverage. This Court should answer Certified Question no. 2(a) by applying the rebuttable presumption of harm. Finally, this Court should answer Certified Question no. 2(b) by applying the estoppel remedy under which the correct measure of damages is the amount of the judgment or stipulated judgment entered against the insured.

Respectfully submitted this 14th day of December, 2007.

KELLER ROHRBACK L.L.P.

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CERTIFICATE OF SERVICE

I am a citizen of the United States and a resident of King County. I am over 18 years of age and not a party to this action. My business address is 1201 Third Avenue, Suite 3200, Seattle, Washington 98109.

On this date, I served the attached document via email on the following parties:

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Daniel L. Syhre
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Dated this 14th Dave of December 2007.

_____
Keith Morton

CERTIFICATE OF SERVICE

I am a citizen of the United States and a resident of King County. I am over 18 years of age and not a party to this action. My business address is 1201 Third Avenue, Suite 3200, Seattle, Washington 98109.

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Keith Morton